CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

November 19, 2001

H.R. 3210
Terrorism Risk Protection Act

As ordered reported by the House Committee on Ways and Means on November 16, 2001

SUMMARY

H.R. 3210 would require an administrator appointed by the President to provide up to $100 billion in financial assistance to commercial property and casualty insurers for losses from terrorist acts committed after enactment of the bill and prior to January 1, 2003. (The administrator would have the authority to extend the program for two more years.) The administrator would provide such assistance only after insured losses exceed $1 billion for the entire industry (or lesser amounts if individual insurance companies are particularly affected as specified by the bill). After either threshold is met, the administrator would pay insurance companies 90 percent of subsequent covered losses. Under the bill, if insured losses from a terrorist act required the administrator to provide financial assistance, the administrator could recoup that cost through charges assessed on the insurance industry and purchasers of commercial property and casualty insurance.

CBO cannot predict how much insured damage terrorists would cause in any specific year. Instead our estimate of the cost of financial assistance provided under H.R. 3210 represents an expected value of payments from the program—a weighted average that reflects the probabilities of various outcomes, from zero damages up to very large damages due to possible future terrorist attacks. The expected value can be thought of as the amount of an insurance premium that would be necessary to just offset the risk of providing this insurance; indeed, our estimate of the expected cost for H.R. 3210 is based on premiums collected for terrorism insurance in the United Kingdom and insurance practices in the United States.

On this basis, CBO estimates that enacting section 6 of H.R. 3210 would increase direct spending by about $7.3 billion over the 2002-2006 period and by $8.5 billion over the next 10 years. Under the bill, the administrator could recoup the costs of providing financial assistance through assessments and surcharges; hence, over many years, CBO expects that an increase in spending for financial assistance would be nearly offset (on a cash basis) by

a corresponding increase in governmental receipts (revenues). We assume, however, that the administrator would not impose any assessments or surcharges until one year after federal assistance is provided and that those amounts would be collected over several years. Thus, CBO estimates that H.R. 3210 would increase governmental receipts by about $1.4 billion over the 2002-2006 period and by $5.3 billion over the next 10 years. Because H.R. 3210 would affect direct spending and receipts, pay-as-you-go procedures would apply.

H.R. 3210 contains several intergovernmental and private-sector mandates, as defined in the Unfunded Mandates Reform Act (UMRA), on insurers and policy holders of commercial property and casualty insurance. CBO estimates that the aggregate net costs of complying with those mandates would not exceed the annual thresholds established by UMRA ($56 million for intergovernmental mandates and $113 million for private-sector mandates in 2001, adjusted annually for inflation).

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 3210 is shown in the following table. The costs of this legislation fall within budget function 370 (commerce and housing credit).

	By Fiscal Year, in Millions of Dollars				
	2002	2003	2004	2005	2006
CHANGES IN DIRECT SPENDING					
Estimated Budget Authority	800	1,700	2,200	1,700	900
Estimated Outlays	800	1,700	2,200	1,700	900
CHANGES IN REVENUES					
Assessments and Surcharges	0	100	200	500	600

BASIS OF ESTIMATE

For this estimate, CBO assumes that H.R. 3210 will be enacted by the end of 2001 and its provisions will remain in effect until December 31, 2004. We estimate that H.R. 3210 would increase direct spending by $8.5 billion and governmental receipts by $5.3 billion over 2002-2011 period.

Direct Spending

H.R. 3210 would require the administrator to provide up to $100 billion in financial assistance to commercial property and casualty insurers for losses above certain thresholds due to future terrorist acts. Under the bill, the administrator would provide such assistance as a result of terrorist acts that occur before January 1, 2003, but the administrator could extend the program to cover events through calendar year 2004. (If the program is extended beyond 2002, we interpret the $100 billion as being an annual limit.) For this estimate, CBO assumes that the administrator would extend the program through 2004.

By offering financial assistance to commercial property and casualty insurers for acts of terrorism, H.R. 3210 would expose the federal government to potentially huge liabilities. For any year, CBO has no basis for estimating the likelihood of terrorist attacks or the amount of insured damage they may cause. Instead, our estimate of the cost of these provisions reflects how much the government might be expected to pay to insurers on average.

In the following sections, we describe our method for estimating the expected-value cost of providing financial assistance under H.R. 3210, explain how we convert that expected-value cost to annual estimates of cash outlays, and discuss some of the reasons why the cost to the federal government is so uncertain.

Terrorism Insurance in the United Kingdom. Because very limited information is available about how the insurance industry would set premiums for terrorism insurance in the United States, we examined the government-backed insurance pool that spreads the risk of terrorist acts among insurers in the United Kingdom (this program is called Pool Re).

CBO could not estimate the cost of H.R. 3210 to the federal government by examining the U.S. insurance industry's perception of the likelihood of terrorist acts. Representatives of the insurance industry have testified that estimating the risk of terrorist acts is nearly impossible because sufficient historical data do not exist. We explored the possibility of using premiums paid in the U.S. for terrorism insurance prior to September 11, 2001, to estimate the minimum premium required to compensate the government for its risk; however, such information is not available. This led us to examine the United Kingdom's experience with terrorism insurance.

In 1993, the British government created Pool Re to provide terrorism reinsurance (insurance for insurance companies) to the commercial property insurance market in the United Kingdom. Participating insurers must offer terrorism coverage at risk-based rates established by Pool Re and then remit any premiums collected from their customers to the pool. After a small deductible, Pool Re pays 100 percent of the costs of a terrorist act. If claims from terrorist acts exhaust the pool's resources, the British government is liable for the shortfall.

Calculating the Expected Value of Claims. Over the 1993-2000 period, annual premiums collected by Pool Re have ranged from about $530 million in the early years of the program to about $75 million in 2000. On average, annual premiums have been roughly $325 million. The pool has reduced its premium rates in recent years as the number of terrorist attacks in the United Kingdom (and the perceived threat of future attacks) dropped. For this estimate, CBO assumes that the average premiums over the eight-year period accurately reflect the terrorist risk to covered losses in the United Kingdom. In some years, there may be many costly attacks; in others, there may be none.

To compare premiums collected by Pool Re to those that would be required to compensate the federal government for its risk under H.R. 3210, we made adjustments to account for differences between Pool Re and the proposed U.S. program. CBO expects that, if premiums were charged to cover the potential costs of H.R. 3210, they would have to be significantly larger than those collected by Pool Re. Pool Re covers losses only for property damage and business interruption, while the program proposed under the bill also would cover casualty and related risks. Based on information from the insurance industry about the relative proportion of property and casualty insurance, we estimate that including these lines would roughly double the premiums required under Pool Re. In addition, CBO increased the average premium amount for Pool Re by a factor of 7 to account for differences in the sizes of the two countries' economies and insurance markets. We did not make any adjustments for differences in the risk of terrorist acts that each country faces because we cannot quantify such differences.

After making the adjustments described above, CBO estimates that the expected-value cost of a federal program that is analogous to Pool Re would be about $4.5 billion a year. However, two key differences between Pool Re and the program outlined in H.R. 3210 require additional adjustments. First, H.R. 3210 would require the industry to absorb losses of $1 billion before the administrator would provide any assistance. By comparison, deductibles required by Pool Re are negligible. Second, H.R. 3210 would cap federal assistance at $100 billion a year; coverage under Pool Re has no cap.

To make these further adjustments, we assumed that the probability of terrorist attacks is skewed toward events that would cost less than $4.5 billion a year. After taking into account the $1 billion industry-wide deductible and the $100 billion cap on federal assistance, CBO estimates that the administrator would need to charge about $3 billion annually for coverage over the 2002-2004 period to fully compensate the government for the risk it would assume under H.R. 3210. Assuming the program operates for three years, the expected cost to the government would total $9 billion. Those outlays, however, would be spread out over many years, as explained below.

Timing of Federal Spending. To estimate federal spending for this program on a cash basis, CBO used information from insurance experts on historical rates at which property and casualty claims are paid. Based on such information, CBO estimates that the expected value of federal spending under H.R. 3210 would total $8.5 billion over the 2002-2011 period, and about $500 million after 2011. In general, following a catastrophic loss, it takes many years to complete insurance payments because of disputes over the value of covered losses by property and business owners. For this estimate, we assumed that financial assistance to property and casualty insurers would be paid over several years, with most of the spending occurring within the first five years.

Costs Are Uncertain. While this estimate reflects CBO's best judgment on the basis of available information, costs are a function of inherently unpredictable future terrorist attacks. As such, actual costs could cover an extremely broad range. Moreover, there is a greater risk that our estimated costs are too low rather than too high.

Our expected losses under this program could be too low because we assumed losses would have to exceed $1 billion before the administrator would provide assistance. Under the bill, however, the administrator also could provide assistance if aggregate losses exceed $100 million and at least one company is particularly adversely affected. In addition, there are a number of differences between Pool Re and the program that would be established under this legislation that are unknown—for example, the difference between U.S. and British tort law—but these differences would push the likely cost of the bill higher.

Revenues

CBO estimates that under H.R. 3210 the administrator would collect $5.3 billion over the 2002-2011 period through assessments on the insurance industry and surcharges on policy holders.

Assessments. If a terrorist act requires the administrator to provide financial assistance, the administrator would recoup that cost through charges paid by the insurance industry and purchasers of commercial property and casualty insurance. The first $18 billion of financial assistance could be recovered by assessing each insurer based on its portion of aggregate property and casualty insurance premiums for the preceding calendar year. Each company's assessment would be limited to 3 percent of aggregate premiums. The administrator could delay when a company would be required to pay the assessment if such a delay were necessary to prevent the insurer from becoming insolvent. Because we assume the probability of terrorist attacks would be skewed toward events that would cost less than $4.5 billion, we anticipate that assessments would account for most of the amounts the administrator would collect. On an expected-value basis, CBO estimates that assessments to recover the cost of federal assistance would generate revenues totaling $4.3 billion over the next 10 years.

Surcharges. The administrator would recover any assistance provided between $20 billion and $100 billion by imposing a surcharge on all premiums for commercial property and casualty insurance. Surcharges would apply to insurance sold following a terrorist attack that necessitated federal assistance. H.R. 3210 would require the administrator to impose surcharges for as long as is necessary to recover the aggregate financial assistance. Thus, the government could collect surcharges for many years depending on the level of financial assistance. We estimate that surcharges would total $1 billion over the next 10 years.

Timing. CBO expects that the administrator probably would not recoup the entire cost of financial assistance during the 2002-2011 period. Based on information from the insurance industry on aggregate premiums collected in recent years, CBO estimates that the administrator could recoup no more than about $10 billion a year. The bill would allow the administrator to reduce annual charges to avoid unreasonable economic disruption, excessive market instability, or undue burdens on small businesses. Therefore, if annual losses are very high, we expect that the administrator would limit annual collections by spreading them over many years. CBO assumes it would take the administrator at least 10 years to recoup the costs of any financial assistance provided under H.R. 3210. Thus, we estimate that many of the collections from assessments and surcharges would occur after 2011.

Risk of Insolvency. In addition, although the bill would allow the administrator to delay when an insurance company pays its assessment, the bill would not provide the administrator with the authority to increase the assessment on the remaining insurance companies if a company is unable to pay. Thus, the federal government also would bear the risk that an insurance company would become insolvent during the assessment period. Historically, the credit risk of insurance companies has been very low, but the government would be exposed to such risk only following a very costly attack. Because we expect the probability of such a costly attack is very low, we included a small adjustment for the risk of insolvency in our estimate.

Credit Reform Does Not Apply. The provisions of the Federal Credit Reform Act do not apply to H.R. 3210. Under that act, a direct loan is defined as a disbursement of funds to a nonfederal borrower under a contract that requires the repayment. A disbursement cannot be considered a direct loan, however, if the duty to repay the government arises from an exercise of sovereign power, tort liability, or some other noncontract obligation. H.R. 3210 would require insurance companies and potentially policy holders to compensate the government for its costs, but it would do so through an exercise of sovereign power, not through loan repayment contracts. Therefore, CBO believes that the financial assistance and subsequent collections would not constitute a loan program.

PAY-AS-YOU-GO CONSIDERATIONS

The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. The net changes in outlays and governmental receipts that are subject to pay-as-you-go procedures are shown in the following table. Only the effects in the current year and the following four years are counted for pay-as-you-go purposes.

	By Fiscal Year, in Millions of Dollars									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Changes in outlays	800	1,700	2,200	1,700	900	500	300	200	100	100
Changes in receipts	0	100	200	500	600	700	800	800	800	800

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

H.R. 3210 contains several intergovernmental and private-sector mandates as defined by UMRA. CBO estimates that the costs to comply with all of the mandates in the bill would not exceed the thresholds established by UMRA ($56 million for intergovernmental mandates and $113 for private-sector mandates in 2001, adjusted annually for inflation).

Assessments and Surcharges

The bill would require the administrator, through the use of the federal government's sovereign power, to recoup the costs of financial assistance provided to certain insurers through assessments paid by the insurance industry and surcharges paid by purchasers of commercial property and casualty insurance. This requirement to repay the federal government for financial assistance received would be both an intergovernmental and private-sector mandate under UMRA because both private entities and state and local governments would be affected.

Specifically, section 7 would require commercial property and casualty insurers as well as self-insured risk pools to pay back, through assessments, 90 percent of either total industry-wide losses or $20 billion, whichever is less. Taken individually, some insurers may benefit from the financial assistance while others face only the cost of the assessment. But for the insurance industry as a whole, the cost of the assessment would be no greater than the financial assistance received, so the net cost of this mandate would be zero.

In addition, section 8 would require purchasers of commercial property and casualty insurance to repay, in the form of a surcharge, any federal assistance provided to certain insurers between $18 billion and $100 billion. Some purchasers of commercial property and casualty insurance would not receive a direct benefit under the bill or protection from higher premiums in its absence. Therefore, the surcharge would be a mandate that imposes costs on both private-sector purchasers and state and local governments (in their capacity as purchasers of insurance). CBO estimates that the expected value of the surcharges on policyholders would total less than $120 million annually over the next five years.

Preemptions

Section 12 would preempt certain state insurance laws by providing that any insurer that complies with the provisions of the bill would be deemed to comply with any state law that regulates insurance for acts of terrorism. This section also would expressly preempt any state laws that limit the amount an insurer could add to premiums to recover any assessments, and laws that require certain actions by insurers in order for rates or policies to be effective.

Section 13 of the bill would require states to adopt uniform guidelines for maintaining certain reserves and disclosing premium costs. Should states fail to adopt these guidelines, the administrator could adopt them on a national basis, superseding any related state laws. Neither the preemptions in section 12 nor the requirements of section 13, which are intergovernmental mandates as defined by UMRA, would impose significant costs on state, local, or tribal governments.

PREVIOUS CBO ESTIMATE

On November 16, 2001, CBO transmitted a cost estimate for H.R. 3210, the Terrorism Risk Protection Act, as ordered reported by the House Committee on Financial Services on November 7, 2001. CBO estimates that the effects on direct spending would be the same under the two versions, but the revenue provisions and their estimated effects would differ. Both versions would increase governmental receipts from assessments and surcharges by an estimated $5.3 billion over the 2002-2011 period. However, the version of the bill ordered reported by the Committee on Financial Services also included provisions that the Joint Committee on Taxation estimated would reduce tax revenues from non-life insurance companies by $12.4 billion over that period. Hence, we estimated that enacting that version would have the net effect of reducing governmental receipts by $7.1 billion over the next 10 years. Because the House Committee on Ways and Means did not include those provisions, CBO estimates that its version of H.R. 3210 would increase governmental receipts by $5.3 billion over the 2002-2011 period.

In addition, while our estimate of total assessments and surcharges under both versions is the same, we estimate that, under the version ordered reported by the House Committee on Ways and Means, a greater proportion of the collections would come from surcharges than under the House Committee on Financial Services' version. While the mandates in both versions of the bill are the same, the higher surcharges would increase the cost of the mandate on purchasers of insurance. However, the aggregate costs of the mandates in both versions would not exceed the thresholds established in UMRA.

ESTIMATE PREPARED BY:

Federal Costs: Mark Hadley, Megan Carroll, and Ken Johnson
Impact on State, Local, and Tribal Governments: Susan Sieg Tompkins
Impact on the Private Sector: Jean Talarico

ESTIMATE APPROVED BY:

Robert A. Sunshine
Assistant Director for Budget Analysis